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UNIT TRUST CORPORATION

ADVISORY SERVICES DEPARTMENT

Newsletter

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An Exchange Traded Fund (ETF)

is a pooled investment vehicle with shares that can be bought or sold throughout the day on a stock exchange at a market-determined price. ETFs were first introduced in the 1990s but they started being used significantly about a decade later. Since then, ETFs have matured and have become one of the most popular investment vehicles for both institutional and individual investors.

FEATURES OF AN ETF

- Listed and traded as individual stocks on a stock exchange
- Indexed rather than actively managed
- Value is based on the underlying net asset value (NAV) of the stocks held in the index basket

ETFs vs MUTUAL FUNDS

Both mutual funds and ETFs can take a passive approach to investing by tracking market indexes, but ETFs offer distinctive differences that set them apart from mutual funds, particularly in terms of tax efficiency, costs and transparency about their holdings.

ETFs are similar to mutual funds because they comprise of a pool of investments. Usually, these investments have something in common and are generally organised around a theme, such as a specific index fund or group of stocks that represent an industry or sector of the economy. However, unlike mutual funds, ETFs can be traded all day long. ETFs combine the valuation feature of a mutual fund, which can be bought or sold at the end of each trading day for its net asset value, with a tradability feature which allows trades throughout the trading day at prices that may be more or less than its net asset value.

Source | iShares by BlackRock

The market price of an ETF is the price at which shares in the ETF can be bought or sold on the exchanges during trading hours, while the NAV is the per share value for a fund. Its NAV represents the value of each share's portion of the fund's underlying assets and cash at the end of the trading day and is computed by subtracting the fund's liabilities from its assets and dividing it by the number of outstanding shares. The formula is shown below:

$$NAV = \frac{\textit{Fund's Assets} - \textit{Fund's Liabilites}}{\textit{\# of Outstanding Shares}}$$

For example, the ABC Fund's assets are \$30,500,000 and liabilities are \$300,000 and there are 10 million shares outstanding. The Fund's NAV is calculated below:

$$NAV = \frac{\$30{,}500{,}000 - \$300{,}000}{10{,}000{,}000} = \frac{30{,}200{,}000}{10{,}000{,}000} = \$3.02$$

It's basically an indication of the fair value of a single share of the fund and it provides investors with a reference point around which they can gauge any offers to buy or sell shares of the fund. The NAV of an ETF is calculated and disseminated to the public on a daily basis and is used to compare the performance of different funds as well as for accounting purposes.

How ETFs work

ETFs are not traded directly with a fund management company. Instead, they are bought or sold any time during stock market trading hours directly through a stockbroker. The open-ended nature of ETFs allows for the creation and redemption of shares in the underlying fund to meet investor demand.

ADVANTAGES OF ETFs

ETFs have some unique characteristics that make them useful for some investors. Some of the advantages are highlighted below:

1. **Portfolio Diversification** – The best reason to choose an ETF over a stock is instant diversification as it gives the investor ownership in a basket of stock instead of a single company, thereby removing company-specific risk which is a huge factor for many investors.

2. **Trading Flexibility** – The ability to create and redeem ETF securities on a regular basis ensures an underlying depth of liquidity. Unlike mutual funds, ETFs can be traded at market prices throughout the trading day, at a price quoted on the stock exchange.

3. **Lower Fees** – ETFs have lower annual fees especially when compared to mutual funds as they are passively managed and therefore have much lower expense ratios compared to other managed funds. Reduced marketing distribution and accounting expenses as well as the absence of fees for a board of directors all contribute to lower fees.

4. **Dividends are reinvested immediately**

RISKS OF ETFs

1. **Market Risk** – This is the single biggest risk. Since ETFs are made up of a basket of securities, they are susceptible to variations is the markets that they track. Therefore, if a market plummets, so too will the ETF tracking it.

2. **Composition Risk** – ETFs are not interchangeable with their underlying indexes. Two ETFs may track the same space, but one ETF might be outperforming the other. This has to do with the difference in asset allocation and can cause one fund's particular lineup of securities and weightings to offer better returns than the other. It is therefore recommended that you acquaint yourself with an ETF's holdings and their weights before purchasing.

3. **Trading Risk** – Like stocks, ETFs have trading spreads, which vary from pennies to dollars. That spread can change over time as well as for the amount of shares you want to trade. Since these costs can quickly erode returns, it is recommended that you research an ETF's liquidity before you buy, and trade with limit orders as needed.

It is almost a consensus that the ETF industry will continue to grow at double-digit rates for several years to come. Many analysts predict that the ETF industry will surpass the hedge fund industry in assets under management (AUM) in the very near future. Also, in the coming years, it is expected that both the users and the uses of ETFs will increase. The continued development of new ETF products is fuelled by the increasing competition between fund issuers, as well as the desire to more precisely tailor ETFs to suit the investment goals of different investors.

ETFs' 2016 PERFORMANCE

According to FactSet data, flows into ETFs were at record levels in 2016. The highest number of flows into US-listed ETFs for any year was set in 2016 at $287.5 billion. In November, US-listed ETFs took in almost $50 billion and then in December, that figure was surpassed with a record number of inflows of $61.5 billion for the month (see Chart 1 and Table 1).

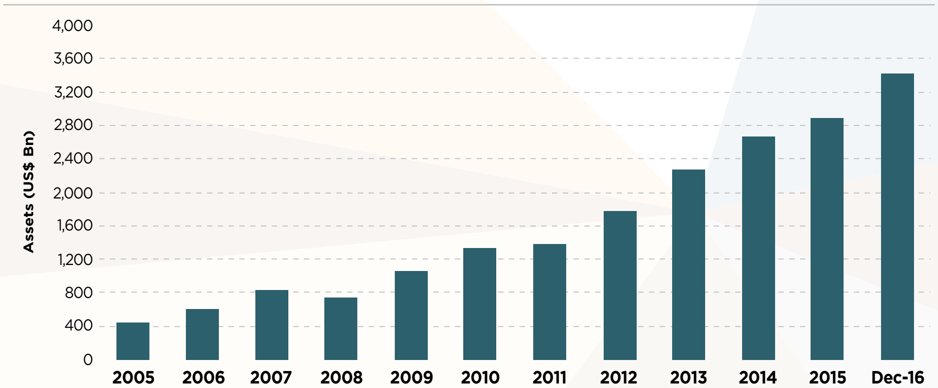

CHART 1 | Global ETF Asset Growth *Source | etfgi.com*

Segment	2016 Inflows
US equity ETFs	$162.5 billion
US fixed-income ETFs	$81.7 billion
International equity ETFs	$15.8 billion
International fixed-income ETFs	$10.9 billion
Commodity ETFs	$10.4 billion

TABLE 1 | 2016 Inflows for US-listed ETFs by Segment

The only segment to see outflows was currency ETFs, with redemptions of $492 million for the year. At the end of 2016, the total US-listed ETF assets now stands at $2.56 trillion.

The remarkable performance of ETFs was however not just limited to the US. According to BlackRock, global ETF inflows totalled $375 billion in 2016, surpassing 2015's total of $348 billion. Chart 2 shows that there will continue to be a high level of demand for ETFs over the next five years.

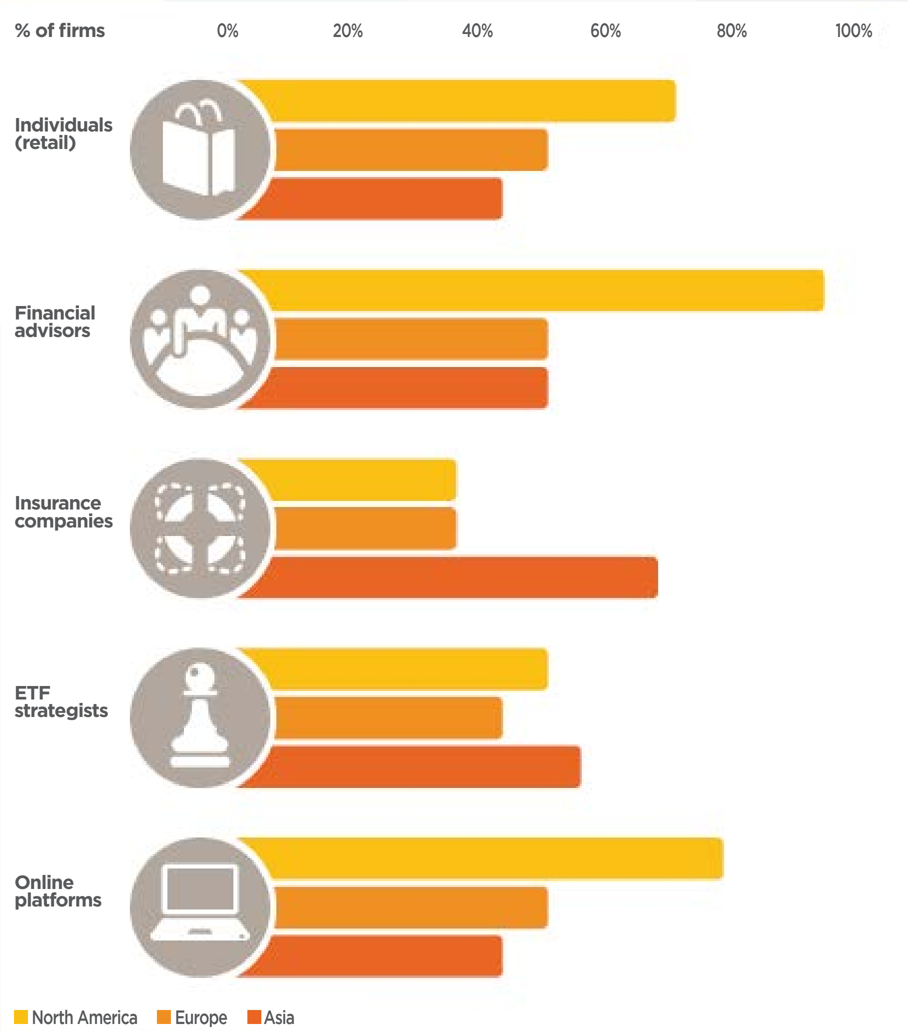

CHART 2 | The expected level of demand for ETFs by investor segments over the next 5 years
Source | PWC, "2nd Annual Global ETF Survey," 2015

There are numerous ETFs, which can present quite a daunting task when deciding where to invest. But you can filter through them by considering the following points:

- **Figure out why you're investing**

  If you're risk-averse and seeking stock exposure, then you may want to look at more stable stock-focused ETFs that invest in large-cap companies. For the more risk-seeking investor who wants higher returns, there are more exotic ETFs.

- **Pay attention to fees**

  People tend to choose ETFs because they are generally cheaper than other fund investments yet some ETFs can be expensive. As an investor, you need to pay attention to the operating expense ratio and trading commissions when considering varying funds.

- **Does the ETF do what it says it does?**

  The purpose of an ETF is to track a specific index, therefore as an investor make sure you understand what the index tracks as well as what the ETF is comprised of.

- **Does the ETF have staying power?**

  To help determine the staying power of an ETF, take a look at its assets and the investor interest. ETFs tend to have low profit margins and therefore need several assets to keep them profitable. Good trading volume is also a positive sign because if there is a substantial buy or sell, it will prevent drastic price changes.

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